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Financial Reform in Japan

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CONTENTS

Introduction

The purpose of this paper is to briefly review recent financial reform in Japan. The problems that the Japanese financial system has been facing are twofold. First, we have to solve the problem of huge bad loans that major financial institutions have been suffering from as a result of the bursting of the so-called "Bubble Economy." Second, we have to drastically reform the Japanese financial system through the so-called "Japanese Big Bang" so that we are able to recover competitive strength in the globalized financial markets. It is certainly not an easy task for us to solve those two problems simultaneously. Nevertheless, wide-ranging financial reform in Japan has been going on now for some time and we should carefully watch its outcome.

Section 1 will discuss central bank reform with particular attention being paid to the revision of the Bank of Japan Law of June 1997. I show how the Bank of Japan has acquired its independence from the government and how its conduct of monetary policy has been changed. Section 2 will present a brief review about the process of financial deregulation in Japan since the late 1970s, focusing on such once-regulated areas as the separation of financial institutions, interest rate ceilings, and capital movements to and from overseas. It will also analyze the causes and consequences of the "Bubble Economy" and its eventual bursting. Section 3 will discuss the implications of the "Japanese Big Bang" for the Japanese financial system. I show how the regulatory and supervisory agencies have been changed in Japan, reviewing the shift of power from the Ministry of Finance to the newly-established Financial Supervisory Agency (the present Financial Services Agency), and how prudential policy in Japan should be changed.

1. Central Bank Reform in Japan

1.1 The Revision of the Bank of Japan Law

The new Bank of Japan Law was promulgated in June 1997 and was enforced in April 1998. The old Bank of Japan Law, which was enacted in February 1947, was revised after the Ministry of Finance (MOF) was criticized for the self-righteous way it administered the financial system, it itself being reorganized in June 1998. Rather ironically, it was not really the efforts of the Bank of Japan (BOJ), but the struggles between the MOF and political parties (particularly, the Liberal Democratic Party) that actually gave birth to the new Bank of Japan Law. Nevertheless, the BOJ now enjoys a more independent legal status under the new Law than under the old Law.

Because the old Law was enacted during the Second World War, the government characterized it with a strong regulatory tone. Article 1 of the old Law determined the purposes of the BOJ as follows:

"The Bank of Japan has as its objective the regulation of the currency, the control and facilitation of credit and finance, and the maintenance and fostering of the credit system, pursuant to the national policy, in order that the general economic activities of the nation might adequately be enhanced."

Under the old Law, the BOJ was put under the strict control of the MOF and was not allowed to be independent from the government at all. For example, the Prime Minister could dismiss the Governor and the Deputy Governor of the BOJ when deemed necessary. The Minister of Finance could dismiss the Executive Directors of the BOJ in the same manner. Furthermore, the MOF could issue directives to the BOJ concerning its overall functions, thereby controlling monetary policy as well as prudential policy of the BOJ.

The new Law clearly states that "the BOJ 's independence regarding currency and monetary control shall be respected" (Article 3). In accordance with that philosophy, the new Law guarantees the status to the Governor, the Deputy Governor, and the other members of the Policy Board of the BOJ in the sense that they shall not be dismissed against their will during their five-year terms (Article 25). Moreover, the MOF cannot issue any directives concerning the business operations of the BOJ, although it may request a report or relevant documents from the BOJ when deemed necessary (Article 58). It should be noted, however, that the BOJ is urged to maintain close contact with the government and to exchange views sufficiently so that its monetary policy and the government's economic policy should be mutually harmonious (Article 4).

The new Law determines that "the objectives of the BOJ are to issue banknotes, to carry out currency and monetary control, and to ensure smooth settlement of funds among banks and other financial institutions, thereby contributing to the maintenance of an orderly financial system" (Article 1). In addition to those objectives, the new Law states that "the principle of currency and monetary control of the BOJ shall be aimed at, through the pursuit of price stability, contributing to the sound development of the national economy" (Article 2). Those statements concerning the objectives of the BOJ are not at all clear since they include not only the objectives, but also the functions of the BOJ such as banknote issue and funds settlement. Besides, it is hard to distinguish the "objectives" stated in Article 1 from the "principle" stated in Article 2. The question arises whether or not the pursuit of price stability is more important for the BOJ than the maintenance of an orderly financial system.

The official view of the BOJ, after the promulgation of the new Law, is that the missions of the Bank are to maintain price stability and the stability of the financial system, thereby laying the foundations for sound economic conditions. The BOJ claims that those two objectives are like "both wheels of a car" and should be pursued simultaneously. However, we should have in mind that conflicts between those two objectives could sometimes occur and the BOJ might have to make a tough choice between them. Besides, since the MOF and the Financial Supervisory Agency (the present Financial Services Agency), which was newly established in 2000, are primarily responsible for maintaining the stability of the financial system, they might urge the BOJ to treat the stability of the financial system as a top priority. We should reiterate that, as the nation's central bank, the BOJ should stick to the maintenance of price stability and, accordingly, the final objective of the BOJ should be focused on it more than the new Law has stated.

1.2 Organizational Change at the BOJ

The organizational structure of the BOJ was changed several times, even under the old BOJ Law. In particular, the Policy Board was established in 1949 as the supreme decision-making body of the BOJ under the direction of the General Head Quarters (GHQ) of the allied forces. Then, the Policy Board consisted of seven members: the Governor of the BOJ, two representatives of the government, and four members appointed by the cabinet. The purpose of establishing the Policy Board was to democratize the decision-making process of the BOJ, but, in fact, it became dormant under bureaucratic maneuvering by BOJ staff and soon it was metaphorically called "the Sleeping Board." Instead, the Executive Board, which consisted of the Governor, the Deputy Governor and the Executive Directors, acted as the *de facto* decision-making body of the BOJ.

In May 1990, drastic organizational restructuring of the BOJ, involving all its departments, was implemented so that the BOJ would be able to cope with a rapidly changing financial environment; namely financial deregulation and the globalization of financial markets. For example, the Credit and Market Management Department was reorganized so as to integrate the monitoring functions vis-à-vis financial institutions with respect to international finance as well as domestic finance. Meanwhile, a new Financial and Payment System Department was set up in order to assume major responsibility for the prudential supervision of financial institutions as well as the maintenance of an efficient and stable payment system. Furthermore, consolidating all operations-related departments, a new Operations Department was set up so that the BOJ could deal more efficiently with various aspects of funds and securities settlement.

After the passage of the new BOJ Law through the Diet in 1997, the BOJ studied how its organization should be changed in accordance with its philosophy of independence from the government and accountability towards the Diet and the general public. In April 1998, the new Policy Board, which comprised the Governor, two Deputy Governors and six Deliberative Members, was established as the sole decision-making body of the BOJ. (Accordingly, the Executive Board was abolished.) At the same time, further organizational reform took effect, as shown in Chart 1. The 13 departments, 2 offices (Secretariat of the Policy Board and the Governor's Office), and 1 institute (Institute for Monetary and Economic Studies) were reorganized into 10 departments, 5 offices, and 1 institute. First, the Secretariat of the Policy Board was strengthened by incorporating the Governor's Office and by absorbing the functions of the media relations section, which had been part of the Policy Planning Department until then. Second, in order to streamline the decision-making process, the Policy Planning

Department, the Financial and Payment System Department, and the Budget and Management Department were changed to become "offices" and their staff were placed under the direct orders of the respective Executive Director in charge. Third, functions performed by the Credit and Market Management Department were transferred to the newly-created Financial Markets Department, which was put in charge of monetary control, and to the Bank Supervision Department, which was put in charge of the surveillance of financial institutions. (Accordingly, the Credit and Market Management Department, which had been the most powerful department in the BOJ for a long time, was abolished.)

Furthermore, in May 2000, operations related to foreign exchange were transferred from the International Department to the Financial Markets Department so as to strengthen monetary control of the BOJ.

1.3 Changes of Functions Performed by the BOJ

The functions of the BOJ do not differ much from those performed by other central banks. Namely, the BOJ performs three major functions: a) issue for the currency, b) banker to banks (more precisely, banker to financial institutions), c) banker to government. We should, however, point out some changes in those functions in relation to the implementation of the new BOJ Law.

First, the BOJ is the sole note issuer in Japan. The banknotes issued by the BOJ are legal tender and have an unlimited circulation for all transactions, both public and private. The Issue Department of the BOJ, as well as its 33 branches all over the country, takes care of the banknotes so that they can be back into circulation in good condition. Also, it employs a wide range of measures such as watermarks and micro-lettering in order to prevent counterfeiting.

As for the amount of issue of BOJ notes, the old BOJ Law stated that the Minister of Finance should determine its maximum. It also stated that BOJ notes must be fully backed up by eligible assets, such as commercial bills, loans, government bonds, foreign exchange, and gold and silver bullion. The new BOJ Law, however, has neither the provision concerning the maximum amount of issue of BOJ notes nor the provision concerning back-up assets. This is a reflection of the fact that the maximum amount of issue has been repeatedly changed in parallel with the increasing demand for BOJ notes. It is also a reflection of the widely-supported recognition that the value of BOJ notes is not necessarily related to what the BOJ has as its assets. Consequently, under the new Law, the BOJ has been given the discretionary power of controlling the issue of BOJ notes. This means, in turn, that it is the responsibility of the BOJ's monetary policy to adequately control the amount of BOJ notes, thereby maintaining the value of the currency (i.e., price stability).

Second, as banker to financial institutions, the BOJ accepts current deposits from financial institutions and extends credit to them. The scope of financial institutions that it extends credit to is somewhat narrower than the one that it accepts current deposits from. BOJ deposits are used as the means of settlement for various transactions among financial transactions, e.g. call and bills transactions. They are also used for the final net settlement of obligations among financial institutions under the Bill and Clearing System, the Domestic Fund Transfer System (the *Zengin* System), and the Foreign Exchange Yen Settlement System. Since October 1988, the BOJ operates an electronic funds transfer system, the Bank of Japan Financial Network System (BOJ-NET), in order to facilitate fund transfers among financial institutions, thereby maintaining an efficient settlements system. Under the new Law, the BOJ is expected to make contributions to the smooth functioning of the settlement system among financial institutions (Article 39). Currently, for example, the BOJ has been restructuring the BOJ-NET so as to introduce real time gross settlement (RTGS) for fund transfers as well as settlement for government bonds, thereby reducing settlement risk.

BOJ lending has been a traditional means of providing credit to financial institutions. The former Credit and Market Management Department frequently utilized loans against collateral (in the form of bills or government bonds) as a means of daily reserve adjustments in the money markets. Meanwhile, it was advantageous for financial institutions to receive the BOJ loans because the official lending rate was usually maintained below money market rates. Since July 1995, however, the relationship between the official lending rate and money market rates was reversed and the BOJ (the present Financial Markets Department) nearly stopped using its loans as a means of daily reserve adjustment. However, BOJ lending to troubled financial institutions increased significantly in the late 1990s.

As for the "Lender of Last Resort" function performed by the BOJ, the new BOJ Law states that the BOJ may provide uncollateralized loans to financial institutions when they unexpectedly experience a temporary shortage of funds due to accidental causes, including computer system troubles (Article 37). Accordingly, the BOJ can independently cope with cases of liquidity shortage at its own judgement. The new Law also states that the Minister of Finance may request the BOJ to provide loans to troubled financial institutions "when deemed necessary for the maintenance of an orderly financial system" (Article 38). In fact, the MOF (and the FSA) frequently requested the BOJ to provide emergency loans to financial institutions which fell into distress in the late 1990s. And most of the BOJ loans outstanding at end-year 1997 (4.6 trillion yen) was provided in accordance with the Article 38 of the new BOJ Law. Such a situation is certainly rather problematic in the sense that easy access to the BOJ loans might have caused "moral-hazard" problems for troubled financial institutions, and that concern for maintaining an orderly financial system might have weakened the independence of the BOJ.[1]

Third, the BOJ plays a role as the bank of the government in the fields of Treasury funds and government securities. Namely, it handles receipts and disbursements of Treasury funds (e.g., tax collection and payment of public works, social welfare etc) and conducts accounting and bookkeeping for the government. It also deals with the whole business related to government securities (mostly, the government bonds), i.e. issuance, registration, coupon payments, and redemption. The Operations Department of the BOJ is responsible for those businesses related to the government. Meanwhile, the Financial Markets Department of the BOJ closely monitors developments in the foreign exchange markets and sometimes makes intervention in the markets as an agent of the Minister of Finance when deemed necessary. The MOF, however, continues to keep the power of intervention in the foreign exchange markets and even under the new BOJ Law the BOJ needs the authorization from the Minister of Finance in order to intervene in the markets (Article 39).

As for BOJ credit to the government, the new BOJ Law states that the BOJ may make loans, without collateral, to the government, and subscribe or underwrite government bonds as prescribed in the exceptional clause of Article 5 of the Fiscal Law (Article 34). It also states that the BOJ may subscribe or underwrite financial bills or other bills issued by the government for temporary borrowing. This is certainly an undesirable amendment to the BOJ law because the financing of public deficits by central bank credit will loosen fiscal discipline, thereby bringing about the problem of inflation afterwards. It should be noted, however, that the MOF has started issuing financing bills (FBs) through public competitive-price auctions in April 1999, switching from the traditional way of issuing them through underwriting by the BOJ.

1.4 Policy Reform of the BOJ

The BOJ's top priority in implementing monetary policy is to ensure price stability, although it is also concerned with several other objectives, such as economic growth, stability of the foreign exchange rate, and equilibrium of the balance of payments. Such a traditional policy stance of the BOJ has been confirmed by Article 2 of the new BOJ Law. Meanwhile, the major instruments of monetary policy for the BOJ are a) changes in the official discount rate, b) market operations in various bills and securities, and c) changes in reserve requirement ratios. All of these three instruments involve financial transactions between the BOJ and financial institutions. They have a direct impact upon various financial markets, through which real economic activities as well as price levels would be gradually affected. In relation to such a transmission mechanism, I would like to consider how the operating- and intermediate-variables of the BOJ's monetary policy have been changed, or otherwise.

First, the operating-variables of the BOJ have always been call and bill rates, ever since Japan's high growth period in the 1960s. Call and bill rates, which are representative interest rates in interbank money markets, are determined through the reserve management of the BOJ. More precisely, under the Law Concerning the Reserve Requirement System of 1957, most financial institutions in Japan are subject to the reserve requirement system and are obligated to place legal reserve deposits (namely, current deposits) with the BOJ. The required reserves of financial institutions are calculated as the product of the required reserve ratio and the average outstanding balance of deposits, debentures etc. during one calendar month. A reserve maintenance period begins from the 16th of that month and ends on the 15th of the next. Several factors cause fluctuations in reserve deposits of financial institutions as a whole and they can be summarized in the following equation called "Demand and Supply of Funds in Money Markets," which is equivalent to the equilibrium equation relating the demand for and the supply of high-powered money:

Increase (decrease) in reserve deposits = Inflows (outflows) of banknotes
+ Payments (receipts) of the Government
+ Provision (withdrawal) of credit by the BOJ

The market operations of the BOJ in conducting the reserve management in this equation and in controlling call and bill rates were characterized as being "defensive." That is, they were "defensive" in the sense that the BOJ neutralized fluctuations in the market factor (the first two items on the right hand side) by its credit provisions or withdrawals on a daily or seasonal basis. Moreover, the BOJ controlled the amount of total credit to financial institutions so as to ensure that an average outstanding balance of reserve deposits held by financial institutions through a maintenance period eventually became equal to the average amount of legal reserve requirement, ignoring the negligible statistical errors. Accordingly, Japanese financial institutions maintained excess reserves almost at zero and minimized the opportunity cost of holding such non-interest-bearing deposits. Under such "defensive" reserve management, the BOJ controlled the call and bill rates by adjusting the path of the "progress ratio of reserve deposits."[2] (The ratio was defined as the ratio of reserve deposits accumulated from the first day of a maintenance period against the total cumulative reserve deposits required for that period.) When the BOJ intended to put upward pressure on call and bill rates, it reduced the "ratio" relative to the standard path. On the other hand, when the BOJ intended to put downward pressure on call and bill rates, it increased the "ratio." It should be added that the official discount rate played a critical role in determining call and bill rates. That is, changes in the official discount rate directly influenced call and bill rates through the announcement effects by revealing the changes in the BOJ's policy intent to the general public.

On September 15th 1998, the final day of a reserve maintenance period, the BOJ provided credit to financial institutions more than sufficient to meet their required reserves, thereby reducing call rates to around 0.25%, which was lower than the official discount rate of 0.5% at that time. Since then, the "defensive" reserve management of the BOJ has changed in such a way that financial institutions hold significant amounts of excess reserves through a reserve maintenance period. In other words, the BOJ has started to influence call and bill rates through the amount of excess reserves, not through the "progress ratio of reserve deposits."

Furthermore, as the BOJ has pursued a so-called "zero-interest-rate policy" (by reducing the overnight call rate almost to zero percent), the amount of excess reserves held by financial institutions as well as the BOJ deposits held by money market dealers has increased tremendously.

Second, in order to strengthen the transmission mechanism of monetary policy, the BOJ has liberalized call and bill markets and has encouraged arbitrage transactions among various money markets since the late 1970s. Types of transactions were significantly diversified in call and bill markets, while the restrictions that prohibited arbitrage between the interbank markets and open markets, such as the *Gensaki* market, were gradually abolished. Meanwhile, new open markets were established, such as the certificate of deposit (CD) markets in 1979, the treasury bill (TB) markets in 1986, and the commercial paper (CP) market in 1987. At the same time, the BOJ gradually included these new open-market-instruments within its market operations, e.g. CD operations in 1986, CP operations in 1989, and TB operations in 1991.

As a consequence, various short-term interest rates in the interbank and open markets in Japan now move almost in parallel with each other through the active arbitrage transactions among those markets. If the BOJ controls call and bill rates as its operating targets, it can also control the interest rates in the other money markets. In other words, the BOJ has secured the smooth transmission mechanism of monetary policy, at least within the boundary of various money markets. It should be noted that the markets for short-term government securities such as TBs and FBs, which have remained underdeveloped in Japan even in the 1990s, have at last become the core market for the BOJ's operations since last year. This is because the MOF has started issuing FBs through public competitive-price auction in April 1999.

Third, among the various financial variables that can be treated as intermediate targets of monetary policy, the BOJ has paid closest attention to the broadly-defined money stock since the latter half of the 1970s. This is because the BOJ recognized the importance of controlling the money stock from its own experience of the great inflation in 1973–74. More precisely, in the third quarter of 1978, the BOJ began to announce quarterly forecasts for broad money (M2 at first and M2+CDs since the second quarter of 1979). The forecasts were made for the coming quarter in terms of the percentage change in the average outstanding balance over the corresponding period of the previous year.

The BOJ, however, did not adopt the monetary targeting policy in the same way as other central banks, such as the Federal Reserve System in the United States and the Bundesbank in Germany. In fact, the BOJ followed a rather pragmatic approach in the sense that it didn't set any target zones for the money stock and treated it as one of a number of important economic indicators in reaching a so-called "comprehensive judgement" about the state of the Japanese economy. Included among those indicators were various interest rates, foreign exchange rates, industrial production, investment/consumption expenditures and so on. Nonetheless, under such a pragmatic approach, the BOJ succeeded in gradually lowering the growth rates of M2+CDs during the late 1970s and the early 1980s. Meanwhile, the rates of increase in nominal GDP and in the GDP deflator followed a declining tend almost in parallel with those of M2+CDs.

In contrast, the growth rates for M2+CDs accelerated into double-digits during the period from the second quarter of 1987 to the first quarter of 1989 and stock prices continued to soar to their historically highest levels around the end of the 1980s. Also real estate prices rose sharply, almost in parallel with stock prices. Such sharp hikes in asset prices constituted the so-called "Bubble Economy" in Japan. Then, as a result of monetary tightening by the BOJ from April 1989 to July 1991, the growth rate for M2+CDs indicated a sharp decline, to around 0%, during 1992–93. (Negative growth rates in the fourth quarter of 1992 and in the first quarter of 1993 were recorded.) At the same time, stock prices as well as real estate prices declined sharply and Japan experienced the bursting of the "Bubble Economy" after 1990. I examine the causes and consequences of the "Bubble Economy" in more detail in Section 2.

After having experienced the "Bubble Economy" during the late 1980s and its bursting afterwards, the BOJ began to question the stability of the relationship between the rate of growth of M2+CDs and the rate of inflation, measured by general price indices. The BOJ argued that inflation, as measured by the consumer price index (CPI) and the wholesale price index (WPI), remained stable at a relatively low level despite abrupt changes in the growth rate of M2+CDs and that monetary policy should shift towards the "comprehensive judgement" approach. In other words, the BOJ began to downgrade the importance of the money stock as the intermediate target of its monetary policy. However, we should remember that the double digit growth of M2+CDs during the late 1980s was one of the major reasons for the "Bubble Economy," and that the BOJ was obviously responsible for the mishandling of the money stock during that period.

Last, but not least, it should be pointed out that the most immediate task for the BOJ's monetary policy at the present moment is not to fight against the inflation problem, but to conquer the deflation problem as an aftermath of the bursting of the "Bubble Economy." As the Japanese economy has been experiencing a prolonged recession in the late 1990s, the BOJ has to fight, for the time being, against the deflation, as measured by the WPI and the CPI, as well as asset prices. Meanwhile, the growth rates for lending provided by financial institutions have sharply decreased in 1998 and 1999, as the Japanese financial system has fallen into a crisis situation after the failures of *Hokkaido Takushoku Bank* and *Yamaichi Securities* in November 1997. The burden of huge non-performing loans as well the capital constraint *a la* Basle Accord of 1988 have been the major causes of such credit crunch.[3] Certainly the new BOJ Law has given independence to the BOJ so that it can fight, more than anything else, against the inflation problem. But, ironically, the BOJ has recently been urged to pursue a zero (or some positive) rate of inflation as its policy target. The BOJ has already reduced the official discount rate to 0.5% (in September 1995) and has pursued a so-called "zero-interest-rate policy" (by reducing the overnight call rate almost to zero percent) since February 1999.

Although the BOJ has lifted the "zero-interest-rate policy" in August 2000, the Japanese economy has still been experiencing a rather serious problem of the deflation. We may consider that such extreme interest-rate policy has revealed the limitations of the traditional policy regime of the BOJ that focused most of its attention on the call rate. Now is the time for the BOJ to fully reconsider its traditional tactics and the strategy of monetary policy.

2. Financial Deregulation and the "Bubble Economy"

2.1 Categorization of Japanese Financial Institutions

Japanese financial institutions can be categorized as shown in Chart 2, based on the type of business conducted and the identity of their customers. The classification is done in the following three stages.

The first stage is whether a financial institution is private or public. The public financial system has quite a big share in the Japanese financial system. In particular, the Postal Saving System, which is operated by the Ministry of Posts and Telecommunications, collects deposits from the public through its extensive network of about 24,000 post offices nationwide. At the present moment it accounts for about one third of total deposits held by the household sector in Japan. The Trust Fund Bureau of the MOF accepts funds from the Postal Saving System together with those from other sources and makes loans and/or investments to public financial institutions as well as public corporations, public enterprises, and local governments through the Fiscal Investment and Loan Program. Included among these public financial institutions is the *Development Bank of Japan,* the *Japan Bank for International Co-operation,* the *Housing Loan Corporation,* and so on.[4]

As the second stage of the classification, private financial institutions are divided into financial intermediaries and other financial institutions. The latter include securities companies (such as *Nomura Securities*). They play a key role in securities markets in Japan through their engagement in brokerage, dealing, selling, and underwriting of stocks and bonds. They also deal in CDs and offer various investment funds, such as money market funds (MMFs). Also included among the latter are money market dealers, which engage in brokerage and dealing in short-term money market instruments in collaboration with the BOJ.

As the third stage of the classification, the private financial institutions are divided into depositary institutions and non-depository institutions. Depository institutions consist of four types: ordinary banks (commercial banks), long-term financial institutions, financial institutions for small businesses, and financial institutions for agriculture, forestry, and fishery. First, ordinary banks consist of city banks, regional banks, and second-tier regional banks (once categorized as *Sogo* banks).[5] The city banks (such as *Tokyo-Mitsubishi Bank* and *Sumitomo Bank*) comprise the largest share among the ordinary banks and have been the most important institutions in the Japanese financial system as the so-called "Main Banks" of large Japanese corporations. Second, long-term financial institutions consist of long-term credit banks (such as the *Industrial Bank of Japan*) and trust banks (such as *Mitsubishi Trust Bank*). However, it should be noted that long-term credit banks have actually vanished after the failures of the *Long-Term Credit Bank of Japan* and the *Nippon Credit Bank* in 1998. Besides, the *Industrial Bank of Japan* set up a financial holding company together with 2 city banks in October 2000. Third, financial institutions for small businesses consist of *Shinkin* banks (and the *Shinkin Central Bank* as their central organization), credit co-operatives (and the *National Federation of Credit Co-operatives* as their central organization), the *Shokochukin* Bank and labor credit associates. Fourth, financial institutions for agriculture, forestry and fishery are organized at the national, prefecture, and municipal levels. The *Norinchukin Bank* acts as a central organization in such a three-tier financial system for Japanese primary industries. It is the biggest institutional investor in Japan, holding the largest portfolio of Japanese government bonds.

Finally, included among non-depository financial institutions are insurance companies, which are divided into life-insurance companies (such as *Nihon Life Insurance*) and non-life insurance companies (such as *Tokyo Marine and Fire Insurance*). Also included among this group of institutions are housing finance companies (*Jusens*), consumer credit institutions, securities finance companies and so on. It should be noted that most of the Jusens have already failed.

2.2 Deregulation of the Separation of Financial Institutions

The Japanese financial system has been characterized by rather strict functional separation among different categories of financial institutions. Such separation of functions has been observed between banks and securities companies, between long-term financial institutions and short-term financial institutions, between deposit banks and trust banks, and between insurance companies and the other financial institutions.

The separation of banking business from securities business existed even before the Second World War as an informal practice, although there were no legal provisions concerning such separation. In the post-war period, the separation was legally established by Article 65 of the Securities and Exchange Law of 1948, which was basically a Japanese version of the Glass-Steagall Act in the United States. The Article prohibited banks from engaging in securities business except in cases where there was an investment purpose or a trust contract. Also allowed as exceptions were banks' businesses of government bonds, local government bonds, and government-guaranteed bonds. However, in actual practice, banks engaged only in the underwriting of government bonds during Japan's high growth period in the 1960s. The other bond businesses allowed by the Law as exceptional cases were in fact prohibited by the administrative guidance (*Gyosei Shido*) of the MOF in order to restrict competition between banks and securities companies.

The separation of long-term finance from short-term finance has been based on the commercial banking philosophy similar to that of the United Kingdom. The philosophy is to make clear distinctions between commercial funds related to transactions of commodities and manufacturing funds related to production in various manufacturing sectors. After the Second World War, the Long-Term Credit Bank Law was enacted in 1952 and, accordingly, long-term credit banks, which specialized in long-term finance and could float financial debentures, were established. The maturity of financial debentures issued by long-term credit banks was set at five years. On the other hand, depository financial institutions (such as city banks) were not allowed to issue deposits with a maturity of longer than three years until 1998. Although there were no legal provisions regarding the maturity of funds raised by those depository financial institutions, the MOF exercised an administrative guidance over the maturity of deposits in order to restrict competition between financial debentures issued by long-term credit banks and deposits issued by depository financial institutions.

As for the separation between banks and trust banks, which are another long-term financial institution, banks were once permitted to conduct trust business as well as banking business when the former trust companies were converted into banks in 1948. In 1952, however, the MOF started to promote the separation between banks and trust banks through forcing trust departments of banks to merge with trust banks. Accordingly, quite a limited number of banks (such as *Daiwa Bank*) continued to engage in trust business after then.

Finally, the separation between insurance companies and the other financial institutions was most strictly enforced by the MOF in the sense that only insurance companies could engage in insurance businesses. Furthermore, even among insurance companies, there was a clear separation between life insurance companies and non-life (marine and fire) insurance companies.

Regulations concerning the business areas of financial institutions have been liberalized starting from the late 1970s, and such deregulation has accelerated during the 1980s. For example, banks were allowed to handle many securities businesses, starting with the over-the-counter sale of public bonds (government bonds, local government bonds, and government-guaranteed bonds) in 1983. They were also allowed to deal in public bonds in 1984. Meanwhile, securities companies developed, through tie-ups with *Shinkin* banks, a new financial instrument, which linked medium-term government bond funds with bank deposits, thereby entering the field of settlement business. As a result, the separation between banks and securities companies gradually blurred. At the same time, the separation between short-term finance and long-term finance gradually blurred as banks increased the share of *de facto* long-term lending (short-term lending with repeated maturity extension) to business corporations. Also an increasing number of banks, including foreign banks, started to engage in trust business.

In June 1991, the Financial System Research Council, an advisory body to the Minister of Finance, published a report entitled "On a New Japanese Financial System" which recommended the restructuring of the Japanese financial system. It concluded that mutual cross-entries among individual financial categories in the form of separated subsidiaries would be the appropriate approach to take towards a new Japanese financial system. At the same time, the Securities and Exchange Council, another advisory body to the Minister of Finance, published a report on the revision of regulations concerning the separation between banking business and securities business. It concluded that the establishment of separated subsidiaries would be appropriate, too. Subsequently, the Law concerning the Reform of the Financial System was enacted in June 1992 and it became possible for ordinary banks, long-term credit banks, trust banks, and securities companies to set up wholly-owned subsidiaries in the designated financial categories, starting from April 1993. Although there were still important restrictions in terms of the type of securities business which banks could engage in (e.g. banks were not allowed to engage in stock-brokerage), the first securities subsidiaries formed by 2 long-term credit banks, 2 trust banks and the *Norinchukin Bank* started operation in July 1993. Similarly, subsidiary trust banks formed by 4 securities companies and the *Bank of Tokyo* (the current *Tokyo-Mitsubishi Bank*) started operation in October 1993. Meanwhile, the big city banks had to wait for a while before setting up securities subsidiaries and/or trust subsidiaries since the MOF worried about the "adverse" impact of those entries upon small securities companies and trust banks.

The timing of deregulation in insurance business was a little later than in the other financial businesses. In 1992, the Insurance Council, another advisory body to the Minister of Finance, published a report on the revision of the Insurance Business Law. Subsequently, the Law was revised in June 1995 so that mutual cross-entries between life insurance companies and non-life (marine and fire) insurance companies were admitted in the form of separated subsidiaries.

2.3 Deregulation of Interest Rates Ceiling and Foreign Exchange Control

In addition to the separation of financial institutions, the regulation of interest rates and the control of foreign exchange transactions have characterized the Japanese financial system.

The agreement on regulating deposit interest rates had its origin in the prewar experiences of repeated banking crises in Japan. There was a strong fear that interest rate competition in gathering deposits would weaken the soundness of depository financial institutions. In December 1947, the Temporary Interest Rate Adjustment Law was promulgated and implemented. The Minister of Finance determined whether or not interest rate regulation was necessary in the light of general economic conditions and then, if necessary, the Policy Board of the BOJ determined the upper limits on deposit interest rates after having consulted with the Interest Rate Adjustment Council. Since then, the regulation of deposit interest rates was strictly maintained for a long period of time and, in fact, was always binding.

Deposit interest rates were steadily liberalized after 1979 when banks started to issue negotiable certificates of deposit (CDs). Large-denomination time deposits bearing market interest rates as well as large-denomination money market certificates (MMCs) were first introduced in 1985. Restrictions on minimum amount and maturity of these new deposits with liberalized interest rates were gradually relaxed thereafter. Interest rates on time deposits became virtually free of any regulation in 1993 and interest rates on demand deposits were fully liberalized in 1994, except those on checking accounts (*Touza-Yokin*) with zero percent regulation.

Now, let us turn our attention to foreign exchange control. During the high growth period in Japan, there was a clear segmentation between domestic and foreign financial markets because of rather strict control of foreign exchange. However, after Japan had shifted from a fixed exchange rate system to a flexible exchange rate system in 1973, such strict control of foreign exchange was gradually eased in line with the international trend of liberalizing capital movements across borders. The Foreign Exchange and Foreign Trade Control Law was fully revised in 1980 and the basic principles concerning international capital movements changed from one of "prohibition" to one of "freely allowed," though regulated in case of emergency.

In May 1984, the Joint Japan-U.S. Ad Hoc Group on the Yen/Dollar Exchange Rate issued a report and suggested a number of measures to deregulate the raising and investing of funds by both Japanese and foreign financial institutions in order to promote the internationalization of the yen. Included among those measures were the removal of yen-conversion limits of banks, the liberalization of Euroyen trading, and the elimination of the so-called "real demand rule" for forward exchange transactions. (The rule stated that forward exchange transactions between banks and their customers should be based on "real" transactions, such as commodity trade.) The lifting of yen- conversion limits contributed to expanding Euroyen interbank transactions as well as interbank Eurodollar transactions with foreign exchange swaps. Those transactions, in turn, contributed to increased arbitrage between domestic interbank and open markets. The elimination of the "real demand rule" contributed to the smoother functioning of the Tokyo foreign exchange market than before, because it contributed to the increased arbitrage between spot and future markets.

It should be added that direct dealing and international brokerage were first introduced in the Tokyo foreign exchange market in 1985 and that the Japan offshore market (JOM) was established in 1986.

2.4 The "Bubble Economy" and its Bursting

In the late 1980s, there were significant changes in the environment surrounding financial institutions in Japan. Deregulation of the separation of financial institutions, interest rate ceilings, and foreign exchange control all contributed to increased competition among financial institutions. The most conspicuous response from depository financial institutions, particularly ordinary banks, to the actual (or potential) loss of their franchise value was to expand loans to less traditional areas, such as the real estate industry and non-bank firms. Moreover, many of those non-banks were bank affiliates whose purpose was to lend to real estate companies and to make equity investments. Banks also expanded their equity portfolios, directly or indirectly through special trust funds (*Tokkin*). Similar behavior was observed on the part of long-term credit banks, trust banks and many of the financial institutions for agriculture, forestry, and fishery.

As has already been stated, the stock prices in Japan continued to soar during the late 1980s apart from a temporary fall on "Black Monday" in October 1987. The *Nikkei* 225 stock price index rose from an average of 12,565 in 1985 to an average of 34,058 in 1989. Meanwhile, the increase in real estate prices in central Tokyo had already started in the early 1980s, but accelerated sharply around 1986–87. The rapid increase in land prices gradually spread to the suburbs of Tokyo and to other major cities in Japan. Several non-monetary factors could be cited as the background to the increase in land prices. That is, a) the demand for offices increased in the metropolitan area as Tokyo became one of the world's financial centers, and b) there were favorable tax treatments for investments in land with respect to inheritance tax and capital gains tax.

It was also true that the economic environment and macroeconomic policy contributed significantly to the increase in those asset prices. The Japanese economy, which had been in recession due mainly to the deflationary impact of the substantial appreciation of the yen after the Plaza Accord in September 1985, exhibited significant recovery in 1987 and 1988. However, the BOJ didn't change its easy monetary policy until 1989, because the general price index, such as the CPI and the WPI, remained stable due to the appreciation of the yen, in stark contrast to the sharp rises in asset prices.

In May 1989, the BOJ tightened its monetary policy by raising its official discount rate from 2.5% to 3.25%. (After that, it was raised another four times until it reached 6% in August 1990.) Meanwhile, in March 1990, the MOF urged private banks to contain the growth in their loans related to real estate (i.e., their loans to real estate companies, construction companies, and non-banks) to less than that of their total lending. Asset prices continued to rise for a while even after these policy changes, but they stopped rising or started to decline around the end of 1989. The *Nikkei* 225 stock price index fell sharply from its peak of 38,917 in December 1989 to its nadir of 14,309 in August 1992. Since then, it recorded new peaks and troughs several times, recording a low of 12,879 in October 1998. Meanwhile, land prices showed a sharp downturn by the end of 1991, and they have been following a declining trend since then. The recent level of land prices in metropolitan commercial areas is at about 1/5 to 1/4 of their peak level.

Using the National Wealth Statistics published by the Economic Planning

Agency in December 1998, we can statistically summarize the "Bubble Economy" in the late 1980s and its bursting after 1990 as follows. The market value of shares increased from 242 trillion yen at the end of 1985 to 890 trillion yen at the end of 1989, and then decreased to 335 trillion yen at the end of 1997. The market value of land increased from 1,oo4 trillion yen at the end of 1985 to 2,365 trillion yen at the end of 1990, and then decreased to 1,659 trillion yen at the end of 1997. That is, total capital losses associated with shares and land from their peaks to the end of 1997 amounted to more than 1,261 trillion yen, which was equivalent to 2.5 times of the nominal GDP of 505 trillion yen in 1997. It should be noted that outstanding loans by private financial institutions increased from 395 trillion yen at the end of 1985 to 660 trillion yen at the end of 1990 and then further increased to 702 trillion yen at the end of 1997.

The quality of loans provided by those financial institutions deteriorated as asset prices fell rapidly. Particularly, most of the loans to real estate companies, construction companies, and non-banks turned out to be non-performing loans. In October 1992, the MOF published a report on current policy concerning the non-performing loan problem. The MOF admitted that the total amount of non-performing loans (bankrupt loans and loans with no interest payments for six months or more) held by city banks, long-term trust banks, and trust banks reached 12.3 trillion-yen at the end of September 1992. The problem continued to expand after then. At the end of September 1995, the total amount of non-performing loans (defined as the sum of bankrupt or past due loans and restructured loans) held by member banks of the Federation of Bankers Association of Japan (*Zenginkyo*) stood at 31 trillion yen. Included among those member banks are city banks, long-term credit banks, trust banks, regional banks, and second-tier regional banks. At the end of September 1998, the total amount of "problem loans" (the much wider definition of non-performing loans) jumped to 73 trillion yen. It increased further to 80 trillion yen at the end of March 1999. Meanwhile, according to the self-assessments made by those member banks in March 2000, the total amount of credit that was included in risk categories II, III, and IV (doubtful credits) stood at 81 trillion yen, which was 12.1% of their total credit amounting to 672 trillion yen.[6]

2.5 The Changing Landscape of the Financial Services Industry

There were not many changes in the landscape of the Japanese financial industry during the high growth period in the 1960s and through the stable growth period in the late 1970s and the early 1980s. Regulatory bodies in Japan, primarily the MOF, strictly controlled new entries into each category of financial institution. Besides, the number of failures of financial institutions was quite limited due to the various regulations that restricted competitive forces. However, such a static landscape started to abruptly change as a result of the bursting of the "Bubble Economy" in the 1990s. Some financial institutions, including major banks (city banks, long-term credit banks, and trust banks) went into bankruptcy because of the burden of non-performing loans, while other financial institutions were forced to merge under the more competitive environment than before.

At the end of March 1992, there were 11 city banks, 3 long-term credit banks, 7 trust banks, 64 regional banks, 66 second-tier regional banks, 440 *Shinkin* banks, and 397 credit co-operatives. Then, the total number of depository financial institutions that belonged to those seven categories was 988.[7] At the same time, there were also 210 securities companies, 27 life insurance companies, 25 non-life insurance companies, 8 housing finance companies (*Jusen*) and so on. The following were the major changes that happened in several categories of financial institution after then.

First, among the city banks, the long-term credit banks, and the trust banks, four major financial groups have been going to be formed. In August 1999, the *Industrial Bank of Japan, the Daiichi-Kangyo Bank,* and the *Fuji Bank* agreed to merge by April 2002 and set up a financial holding company named the *Mizuho HD* (Holding) in September 2000. In April 2000, the *Sumitomo Bank* and the Sakura Bank agreed to merge and to establish a new bank named the *Mitsui-Sumitomo Bank* by April 2001. In April 2000, the *Tokyo-Mitsubishi Bank* and the *Mitsubishi Trust Bank* agreed to set up a financial holding company named the *Mitsubishi-Tokyo Financial Group* by April 2001. In October 2000, the *Sanwa Bank,* the *Tokai Bank,* and the *Toyo Trust Bank* agreed to set up a financial holding company named the *UFJ* (United Financial Group of Japan). Meanwhile, the *Hokkaido Takushoku Bank* failed in November 1997. The *Long-term Credit Bank* and the *Nippon Credit Bank* failed in October and November 1998 respectively.

Second, there occurred several failures of second-tier regional banks until 1996. For example, the *Toho Sogo Bank* failed in April 1992. Then, failed the *Hyogo Bank* in 1995, the *Taiheiyo Bank* in May 1995, and the Hanwa Bank in November 1996. Furthermore, there occurred five failures of second-tier regional banks in 1999, i.e., the *Kokumin Bank* in April, the *Kohuku Bank* in May, *the Tokyo Sowa Bank* in June, *the Namihaya Bank* in August, and the *Niigata Chuo Bank* in October respectively. Also, many of *Shinkin* banks as well as credit co-operatives failed. At the end of March 2000, the total number of *Shinkin* banks and credit co-operatives decreased to 386 and 292 respectively as a result of those failures as well as mergers among them.

Third, among the so-called "Big Four" of Japanese securities companies, the *Yamaichi Securities* failed in November 1997. Also, among middle-sized securities companies, the *Sanyo Securities* failed in November 1997. Meanwhile, there occurred several mergers among middle-and small-sized securities companies in line with the consolidation of the above-mentioned four major financial groups.

Fourth, there occurred several failures of life insurance companies as well as non-life insurance companies. In June 1999, the *Toho Life Insurance* failed. Then, in May 2000, the *Daiichi Fire & Marine Insurance* and *the Daihyaku Life Insurance* failed. Also, failed *the Taisho Life Insurance* in August, the *Chiyoda*

Life Insurance and the *Kyowa Life Insurance* in October of the same year. Meanwhile, several cases of mega mergers among major insurance companies have been rapidly proceeding in 2000.

Fifth, and the last, 7 out of the 8 housing finance companies (*Jusens*) failed and the Housing Loan Administration Corporation took over their assets in August 1996.

3. The "Japanese Big Bang" and Supervisory Reform

3.1 The "Japanese Big Bang"

In November 1996, Prime Minister Hashimoto announced a financial deregulation package for drastically reforming the Japanese financial system. The aim of the package was to revitalize the Japanese (particularly Tokyo) financial market by transforming it to a "free, fair, and global" market by the year 2001. The "free" market meant a liberalized market under market principles; the "fair" market meant transparent and reliable markets; and the "global" market meant an international and advanced market. The financial deregulation package was named the "Japanese Big Bang" after "The Big Bang" of the London financial market in October 1986.

Such drastic reform of the Japanese financial system was proposed at that time because the Japanese financial market had been gradually "hollowing out" in the 1990s. For example, transaction volume in the Tokyo stock exchange decreased sharply after 1990. And many Japanese companies continued to issue their corporate bonds in overseas markets, avoiding the cumbersome procedure of issuing in the domestic bond market. Meanwhile, in the 1990s, the growth rates of transaction volume in the Tokyo foreign exchange market became significantly lower than the growth rates in the New York and the London foreign exchange markets. Moreover, the use of the yen as an international currency was not advanced at all. Such "hollowing out" phenomena observed in the 1990s were partly due to the bursting of the "Bubble Economy," but they were also due to the insufficient infrastructure of the Japanese financial system, e.g. remaining various financial regulations, unfavorable tax system for investors, and opaque accounting system.[8] In fact, we should admit that the gradual process of financial deregulation in Japan since the late 1970s was too slow to catch up with the rapid developments in the other globalized financial markets (not only in New York and London, but also in Hong Kong and Singapore).

In response to the initiative of Prime Minister Hashimoto, the MOF acted quickly as a promoter of the "Japanese Big Bang," realizing that its power of financial administration was at stake. In November 1996, the Minister of Finance Mitsuzuka requested each of the five councils (the Securities and Exchange Council, the Business Accounting Council, the Financial System Research Council, the Insurance Council, and the Foreign Exchange Council) to start deliberations on the reform proposals. Among those five councils, the Foreign Exchange Council was the first to have submitted a report, which called for abolition of almost all of the foreign exchange controls. Accordingly, in May 1997, the Diet passed a bill to amend the Foreign Exchange and Foreign Trade Control Law, which was renamed the Foreign Exchange and Foreign Trade Law and was enforced in April 1998. Under the new Law, the purchase and sale of foreign currencies was liberalized, and the permission and prior notification requirement on capital transactions was abolished. That is, the liberalization of cross-border securities transactions and foreign deposits has greatly expanded the choice of investments for business companies as well as for individuals. Besides, many business companies have benefited from the liberalization of the foreign exchange netting scheme. Such drastic deregulation of foreign exchange control as well as capital movements to and from overseas has been called the "front runner" of the "Japanese Big Bang."

Subsequently, in June 1997, the Financial System Research Council, the Securities and Exchange Council, and the Insurance Council submitted to the Minister of Finance reports on specific measures for financial reform in the areas of banking business, securities business, and insurance business respectively. All the reports included specific measures for financial reform and proposed target dates for the implementation of those measures, although the stance for financial reform varied significantly among them. On the one hand, the report by the Securities and Exchange Council took the most active stance for the implementation of a financial reform. On the other hand, the report by the Insurance Council took a rather defensive stance, trying to protect the vested interests of the insurance industry. Summing up the reports submitted by the individual councils, the MOF released a report entitled "Financial System Reform" with the timetable and details of the reform attached. Then, in June 1998, the Diet passed the so-called "Financial System Reform Law," which amended 22 related laws (Banking Law, Securities and Exchange Law, Insurance Law, and so on).

The contents of the "Financial System Reform Law" are too extensive to be covered item by item. Nevertheless, they can be summarized, with reference to the MOF's report in June 1997, from the following four perspectives. First, the Law aims to expand choice for investors and borrowers. More specifically, the ban on securities derivatives (e.g. options on individual stocks) was completely lifted in December 1998. And, in order to promote the use of asset-backed securities (ABS), special purpose companies (SPC) were approved in September 1998. Meanwhile, banks have been allowed to engage in the direct sale of securities investment trust, as well as over-the-counter (OTC) derivatives since December 1998. Furthermore, banks will be allowed to engage in the direct sale of stocks by October 1999, although they have to wait until 2000 before they start selling insurance policies related to housing loans.

Second, the Law aims to improve the quality of services provided by financial intermediaries by increasing competition among them. More specifically, the business scope of separate subsidiaries will be expanded. (Remaining restrictions on securities subsidiaries and trust subsidiaries were fully lifted by October 1999.) Meanwhile, the licensing regime for securities companies was replaced by a registration regime in December 1998, and brokerage commission for stock trading was fully liberalized by October 1999. Furthermore, restrictions on borrowing instruments (bonds and CPs) of non-bank financial firms were abolished in May 1999. It should be noted that holding companies for financial institutions were allowed in December 1997.

Third, the Law aims to develop a more useful market. More specifically, the restriction of off-exchange market trading for exchange-listed stocks was abolished in December 1998. (The electronic-based private transaction system for stocks was liberalized.) And, the registered OTC stock market (JASDAQ) will be improved so that it can function equally well as the Tokyo Stock Exchange. Meanwhile, in the short-term money markets, competitive price auctions of FBs were implemented for the first time in April 1999, as has already been stated in Section 1.

Fourth, but by no means least, the Law aims to establish a framework and rules for fair and transparent transactions. More specifically, the accounting system has been improved to some extent in the sense that there has been a shift towards the disclosures based on consolidated accounting, starting from April 1999. And, starting from April 2001, new accounting standards for financial instruments, such as securities and derivatives, will be established so as to introduce extensively the use of market value accounting (MVA). Moreover, the Law aims to formulate rules, which govern the explanation of non-depository financial products to consumers. In July 1999, the Financial Council of the MOF published an interim report and pointed out that clear rules concerning the merchandising and solicitation of various new financial products (such as derivatives and investment trusts) were necessitated. Accordingly, the Financial Services Act, which sets rules for financial transactions and protects consumers, has been promulgated in May 2000 and will be enforced in April 2001. Meanwhile, "prompt corrective action," based on capital ratios, was introduced in April 1999, as is mentioned later in this Section, and new measures for preventing international money laundering were taken on enactment of the new Foreign Exchange and Foreign Trade Law in April 1998.[9]

3.2 Changing Supervisory Agencies and the Safety Net

Almost in parallel with the implementation of the "Japanese Big Bang," the regulatory and supervisory regime of the Japanese financial system, including the MOF itself, has experienced rapid change in the late 1990s. Before assessing the implications of such changes for prudential policy in Japan, I will briefly review how the regulatory and supervisory agencies, including the Deposit Insurance Corporation, have already been changed.

After the Second World War, the MOF continued to be the dominant power with respect to financial regulation and supervision. According to the Ministry of Finance Law of 1949, the MOF was responsible for the following seven areas of administration; a) treasury, b) currency, c) finance, d) foreign exchange, e) securities transactions, f) mint, and g) printing. Before the drastic reorganization in 1998, the organization of the MOF consisted of the Minister's secretariat and 7 bureau such as the Budget Bureau, the Tax Bureau, the Customs and Tariffs Bureau, the Financial Bureau, the Securities Bureau, the Banking Bureau, and the International Finance Bureau.[10] Among those bureau of the MOF, the Banking Bureau, the Securities Bureau, and the International Finance Bureau played an important role as regulatory and supervisory agencies for various types of financial institutions. First, the Banking Bureau was responsible for the regulation and supervision of most of the financial institutions, such as city banks, long-term credit banks, trust banks, regional banks, second-tier regional banks, and *Shinkin* banks, under the Banking Law and other special laws. Also, its Insurance Department was responsible for the regulation and supervision of insurance companies. Second, the Securities Bureau was responsible for the regulation and supervision of the Stock Exchange and securities companies under the Securities and Exchange Law. Third, the International Finance Bureau was responsible for the regulation and supervision of capital movements to and from overseas under the Foreign Exchange and Foreign Trade Control Law. In addition to those three bureau, the Inspection Department of the Minister's Secretariat conducted on-site examinations of financial institutions, while the Securities and Exchange Surveillance Commission played a role as the guardian of securities transactions in general.

Although the MOF has been the major regulatory and supervisory agency for almost all Japanese financial institutions, including public financial institutions, there are some exceptions. For example, credit unions are under the direction of prefecture governments. Meanwhile, the *Shokochukin Bank* is primarily under the direction of the Ministry of International Trade and Industry, and financial institutions for agriculture, forestry, and fishery are primarily under the direction of the Ministry of Agriculture, Forestry, and Fishery. As for the public financial institutions, the most notable exception is the Postal Saving System, which is solely managed by the Ministry of Post and Telecommunications.

In the late 1990s, the mighty MOF began to be sharply criticized by political parties (particularly, the Liberal Democratic Party) as well as the general public in relation to its mishandling of the *Jusen* failures. The MOF decided to inject public funds of 685 billion yen in order to offset the loss incurred by the *Jusen,* but did not give a clear explanation as to why public funds were necessary. To make matters worse, misconduct by MOF's senior bureaucrats was coincidentally disclosed to the general public. (They quite often received lavish entertainment from private financial institutions.)

In February 1996, the ruling coalition parties (i.e., the Liberal Democratic Party, the Social Democratic Party, and the New Party *Sakigake*) started a project for the thorough revision of the administration of the financial system, with particular attention being paid to the role played by the MOF.[11] In September 1996, the project team released a report which suggested that the MOF's departments related to financial administration should be streamlined. In

December 1996, the ruling coalition parties reached an agreement such that the Financial Supervisory Agency (FSA) should be newly established as an agency of the Prime Minister's Office and that it should be in charge of inspection and supervision of private financial institutions. They also reached an agreement such that the Banking Bureau and the Securities Bureau of the MOF should be abolished.

The Diet passed a bill to establish the FSA in June 1997. Subsequently the FSA was established in June 1998 as the agency that is mainly responsible for the regulation and supervision of private financial institutions. At the same time, the MOF was drastically reorganized. The Securities and Exchange Surveillance Commission was transferred from the MOF to the FSA. The Banking Bureau and the Securities Bureau of the MOF were abolished, while the Financial Planning Bureau was newly set up within the MOF in order to be responsible for the planning of the financial system. The Minister's Secretariat was reorganized to take charge of the supervision of public financial institutions, and the International Finance Bureau was reorganized to some extent and was renamed the International Bureau. (See Chart 3.)

Furthermore, in December 1998, the Financial Reconstruction Commission (FRC), with the Minister of State as its chairman, was newly established as a temporary agency that would take control of the FSA. The final report of the Administration Reform Council, led by the former Prime Minister Hashimoto, suggested that the FSA should evolve into the Financial Services Agency (the new SFA), which is to be totally responsible for prudential policy in Japan, around the start of 2001. In July 1999, the Diet passed a bill for the Reorganization of Ministries and Agencies of the Central Government. Accordingly, the FSA has become the Financial Services Agency (as an agency of the Prime Minister's Office) and has absorbed the Financial Planning Bureau of the MOF in July 2000. Then, in January 2001, the new FSA will take over the job of the FRC and will become responsible for most of the administration of the financial system. Meanwhile, the MOF will be renamed the *Zaimu-sho* (the Ministry of Finance in English), which is responsible mainly for the budget, tax collection, treasury, and international finances. However, it is expected that the *Zaimu-sho* will continue to be involved in prudential policy, particularly in the crisis management of failed financial institutions, together with the new FSA.

Now, let us briefly explain about the Deposit Insurance System in Japan, since it has played an important role in dealing with the Japanese financial crisis in the 1990s. The Deposit Insurance Corporation (DIC) was established under the Deposit Insurance Law, which was promulgated in April 1971. The current Deposit Insurance Law stipulates that the aim of the DIC is to protect depositors with a view to maintaining the stability of the financial system. The DIC can make insurance payments (i.e. pay-offs) to depositors in the event of the suspension of deposit repayments of its member financial institutions. The DIC can also extend "financial assistance" to facilitate mergers or acquisitions of failed financial institutions.

Currently the maximum *de jure* amount of payment is 10 million yen per depositor of a failed financial institution. However, in June 1995, the MOF publicly announced in the report entitled "Reorganizing the Japanese Financial System" that there would be no pay-off until the end of March 2001. In other words, the MOF guaranteed all the deposits of failed financial institutions until that date, as an emergency measure. Furthermore, in May 2000, the Deposit Insurance Law was revised so that all the deposits will be protected in full amount until the end of March 2002. Besides, demand deposits will be protected in full amount for another one year.

Financial institutions that are legally obligated to participate in the Deposit Insurance System in Japan include all the following types: a) banks (city banks, regional banks, second-tier regional banks, trust banks, and long-term credit banks), b) *Shinkin* banks, c) credit co-operatives, and d) labor credit associates. Member institutions must pay insurance premiums, which are calculated by multiplying the premium rate and the total amount of insured deposits and other liabilities. The insurance premium rate was raised from 0.012% of eligible liabilities to 0.084% in April 1996 and has been maintained at that level until now. (In March 1999, the MOF determined to maintain the premium rate at the same level until the end of March 2001.) Meanwhile, the deposits and other liabilities of member institutions that are legally insured under the System are as follows: a) deposits, b) installment savings, c) money-in-trust, of which principal is guaranteed (such as loan trusts and jointly managed money trusts). However, in December 1997, the MOF announced that the other liabilities of failed financial institutions, such as debentures, foreign-currency denominated deposits, and so on, which were not legally insured, would be protected, too, until the end of March 2001. That is, the safety net by the DIC has been temporarily expanded so as to protect most of the liabilities of failed financial institutions. Furthermore, in May 2000, the Deposit Insurance Law was revised so that debentures held by individuals as well as earned interests on deposits would be protected, too.

The Resolution and Collection Bank (RBC) and the Housing Loan Administration Corporation (HLAC) have worked closely with the DIC in recent cases of failed financial institutions. The origin of the RBC was the *Tokyo Kyodo Bank,* which was established in order to take over the business of two failed credit co-operatives, i.e. *Tokyo Kyowa Credit Co-operative* and *Anzen Credit Co-operative,* in March 1995. Then, in September 1996, the *Tokyo Kyodo Bank* was restructured to establish the RCB in order to facilitate the disposal of failed credit co-operatives. The DIC provided the RCB with a capital subscription of 12 billion-yen and set up the "Special Account for Credit Co-operatives" in accordance with the amendment of the Deposit Insurance Law. Meanwhile, the HLAC was established in order to take over the assets of the failed *Jusen* in July 1997. At the same time, the DIC set up the "Financial Stabilization Contribution Fund" of about 1 trillion-yen by collecting contributions from private financial institutions (city banks, long-term credit banks, trust banks, etc) related to the *Jusen*. In April 1999, the RBC and the HLAC merged to establish the Resolution and Collection Company (RCC), which has been playing an important role as a "servicer" by collecting bad loans in collaboration with the DIC.

3.3 The "Convoy" Type Administration and Capital Injection

The MOF's traditional way of administering the financial system was characterized by various kinds of regulations in order to restrict competitive forces in financial markets, thereby protecting individual financial institutions. It was metaphorically described as a "convoyed fleet vessels" type (or simply "convoy" type) of administration of the financial system in the sense that it protected even the weakest financial institution from falling into bankruptcy. However, under the circumstances of financial deregulation and internationalization since the late 1970s, the "convoy" type administration by the MOF was forced to gradually change, as it became difficult to maintain regulations that restricted competitive forces. In fact, we can point out some cases where financial institutions fell into distress because of reckless management and for other reasons (e.g. the failure of *Heiwa Sogo Bank* in 1985). Therefore, the MOF could not maintain, literally speaking, the "convoy" type administration even before the bursting of the "Bubble Economy."

In the case of troubled financial institutions, the Banking Bureau of the MOF tried to solve the problem by forcing them to be absorbed by much larger and/or healthier financial institutions that had close relationships with them. Also, the MOF requested the resignation of the managers of the former institutions so as to take responsibility for their failures. Consequently, the timing and the way of solving these cases were solely dependent on the discretion of the MOF's senior bureaucrats. In fact, they considered that those cases would offer challenging opportunities for showing their administrative skills and powers. Such a traditional way of dealing with troubled financial institutions was maintained even after the "financial assistance" by the DIC was introduced as a legal procedure for dealing with troubled financial institutions. In April 1992, the DIC provided, for the first time, "financial assistance" to *Iyo Bank* that acquired the failed *Toho Sogo Bank*. In June 1996, the DIC introduced the "special financial assistance" that expanded the amount of the "financial assistance" beyond the pay-off costs. (The "special financial assistance" is to protect deposits and other liabilities in full until the end of March 2001.) In December 1997, the DIC temporarily expanded the range of recipients of the "financial assistance" to include financial institutions that would be established through a merger of two or more failed financial institutions.[12] Thus, the MOF tried to maintain its discretionary power of dealing with troubled financial institutions by utilizing those means provided by the DIC.

However, as the number of failed financial institutions increased, the amount of "financial assistance" as well as "special financial assistance" increased so rapidly that the outstanding balance of the Deposit Insurance Fund was nearly exhausted by the end of 1997.[13] Moreover, failures of *Yamaichi Securities* and *Hokkaido Takushoku Bank* in November 1997 put the Japanese financial system into a serious financial crisis and the premium rate that Japanese financial institutions had to pay in raising funds in overseas markets (the so-called "Japan premium") jumped up suddenly. In responding to the worsening situation, in February 1998, two laws on emergency measures aimed at stabilizing the Japanese financial system (the so-called "Financial System Stabilization Law") were promulgated and implemented. According to them, the DIC was provided with public funds totaling 30 trillion-yen. More precisely, it was provided with funds totaling 17 trillion-yen that would be available for use in the disposal of troubled financial institutions (the "Special Business Account"). The fund was to be disbursed through the RCB, which was reorganized to deal with troubled cases of city banks, long-term credit banks, trust banks and so on, in addition to credit co-operatives. The DIC was also provided with funds totaling 13 trillion-yen that would be available for recapitalization of viable private financial institutions for the sake of stabilizing the financial system (the "Financial Crisis Management Account"). The Financial Crisis Management Examination Board, which was established within the DIC in order to implement the recapitalization, decided to inject a total of 1.8 trillion-yen to 21 major banks (city banks, long-term credit banks, trust banks, and regional banks) in March 1998, after having examined their restructuring plans. (The *Long-Term Credit Bank* and *Nippon Credit Bank,* both of which failed later in the same year, were included among those 21 major banks.)

Furthermore, in October 1998, nine laws related to the soundness and reconstruction of the financial system were promulgated and implemented. Among those laws, the so-called "Financial Reconstruction Law" provided a legal framework for the failure resolution of financial institutions, i.e. a) placement under the financial reorganization administrator, b) temporary nationalization, and c) bridge bank. (It should be noted that the FSA assumed the role of implementing those laws from the MOF.) And the public funds available for the DIC were enlarged to 60 trillion-yen. More precisely, the DIC was provided with additional funds totaling 18 trillion-yen that would be available for use in compensating costs required in those procedures. (Under this framework, the *Long-Term Credit Bank of Japan* and the *Nippon Credit Bank* were placed under state control.) At the same time, the so-called "Financial Function Early Strengthening Law" provided a new framework for the recapitalization of viable financial institutions. The "Financial Crisis Management Account" of the DIC was renamed the "Financial Function Early Strengthening Account" whose total funds were increased to 25 trillion-yen. Under this framework, public funds totaling 7.5 trillion yen were injected into 15 major banks in order to enhance their capital bases in March 1999. There were capital injections of public funds to some of the regional banks and the second-tier regional banks during the fiscal year 1999.

In summary, the current comprehensive safety net, which is effective until the end of March 2001, includes a framework for capital injection using public funds, the full protection of deposits and other liabilities of depository financial institutions, and a scheme to establish public bridge banks or temporarily nationalize banks. The total cost of such a safety net has already added up to about 70 trillion yen (about 14% of Japanese GDP). Although those emergency measures were necessary in order to cope with the financial crisis in Japan in the late 1990s, we should be very much concerned about the moral hazard problems that the safety network has created for financial institutions as well as depositors.

3.4 Prudential Policy Based on Market Disciplines

In order to achieve the purpose of maintaining a sound and stable financial system, it is very important to set up a financial environment in which market discipline could prevail. Certainly, zero-failures of financial institutions should not be considered as the final objective of prudential policy, because the soundness and efficiency of the financial system could not probably be achieved under such circumstances.

In contrast, the "convoy" type administration by the MOF was basically one to restrict competitive forces and to protect all financial institutions. The MOF relied on measures such as detailed ex-ante regulations and one-on-one guidance to individual financial institutions. Consequently, even those financial institutions that were inefficient and exposed for too many risks continued to survive. At the same time, however, financial institutions became indifferent to their risk management and their own responsibilities. Under such circumstances, it was quite natural that they were encouraged to adopt the "do as-everyone-else-does" attitude. For example, during the "Bubble Economy" in the late 1980s, most Japanese financial institutions extended too much credit to the real estate-related industry without paying due attention to the concentration risk.

Another result of the "convoy" type administration was the lack of incentives for Japanese financial institutions to develop new financial products. The cumbersome procedure for getting the permission of the MOF in order to introduce new financial products quite often prevented the innovative financial institutions from getting entrepreneurial profits. Consequently, Japanese financial institutions offered only very similar financial products, and the Japanese financial system was often called "the system without innovations". For example, those financial services that have recently been introduced or will soon be introduced by the "Japanese Big Bang," such as options on individual stocks, wrap accounts of securities companies, and defined contribution pension plans were developed a long time ago in the other major countries. That is, Japan has been far behind most major countries in this respect.

Therefore, first of all, both the regulatory and supervisory agencies and financial institutions in Japan must recognize philosophies concerning the importance of market mechanisms. That was one reason why the "Japanese Big Bang" was necessitated. The three catch phrases of the "Japanese Big Bang," namely, a "free, fair, and global" market, means that the Japanese markets should be changed into one where market disciplines would prevail. It is expected that the wide-ranging liberalization measures proposed in the "Japanese Big Bang" would promote competition among various types of financial institutions (both domestic and foreign). The increased competition will surely urge those financial institutions to be more innovative in developing new financial instruments in order to survive. It will also urge them to be more skilful in the measurement, undertaking, and management of various financial risks in their portfolios.

On the side of the regulatory and supervisory agencies, it is expected that the newly established FRC-FSA (and the new FSA) will not continue the "convoy" type administration of the MOF, but instead will adopt prudential policy based on market discipline. In this regard, the capital ratio requirement *a la* Basle Accord of 1988 has important implications for prudential policy in Japan. That is, starting from April 1999, the FRC-FSA (and the new FSA) has adopted the "prompt corrective actions" against those financial institutions with low capital ratios. More precisely, financial institutions that engage in international finance business are now classified by their capital ratio(r) *a la* Basle Accord as follows: a) being sound if $r \geqq 8\%$, b) being under-capitalized if $8\% > r \geqq 4\%$, c) being significantly under-capitalized if $4\% > r \geqq 2\%$, d) being extremely under-capitalized if the $2\% > r \geqq 0\%$, and e) being bankrupt if r is negative. The cut-off ratios for financial institutions that engage only in domestic finance business are 4%, 2%, 1%, and 0% in cases a), b), c), and d) respectively. And, in fact, the FRC-FSA (and the new FSA) have already ordered "prompt corrective actions," by applying those criteria to *Kohuku Bank* and *Hokkaido Bank* in April 1999, to *Tokyo Sowa Bank* and *Niigata Chuo Bank* in May 1999 and to *Namihaya Bank* in June 1999. Among those banks, *Kohuku Bank, Tokyo Sowa Bank,* and *Namihaya Bank* were put into bankruptcy procedures, as determined by the Financial Reconstruction Law.

The FRC-FSA (and the new FSA) is also expected to conduct on-site examination of financial institutions more rigorously than the MOF, which performed a role of not only regulating and supervising, but also protecting and promoting financial industries. In April 1999, they published the new manual of on-site examination of financial institutions so that the definitions of non-performing loans as well as the criteria for loan write-offs and loan provisions would be clarified. Now, they intend to conduct on-site examination of financial institutions more frequently than the MOF did. According to the FRC-FSA (and the new FSA) plan, Japanese banks will be examined in principle once every year, while securities companies, insurance companies, and foreign banks will be examined in principle once every three years. Since the staff of FRC-FSA (and the new FSA) is quite limited (about 400 in total), it should be noted that the BOJ conducts on-site examination of financial institutions, too. The new BOJ Law clearly determined that the BOJ might enter a contract with the corresponding financial institutions (with deposits and/or loan transactions) regarding on-site examination (Article 44). The BOJ has recently announced its supervision policy such that it will strictly check non-performing loans as well as the risk management of financial institutions. It is expected that the FRC-FSA (and the new FSA) and the BOJ will closely co-operate with each other so that they can enhance the flexibility of their on-site examinations.

As I have already stated, the FRC-FSA (and the new FSA) has already been primarily responsible for prudential policy in Japan. However, there remain several questions concerning the role of the new FSA. First, what should be the division of work between the new FSA and the *Zaimu-sho* in financial crisis management? Second, should the public financial system, such as the Postal Savings System and public financial institutions, be regulated and supervised by the new FSA, too? Third, what should be the division (or the integration) of work between the new FSA and the BOJ in on-site examinations of financial institutions?

Notes

1. In providing loans to troubled financial institutions, the BOJ has been insisting that the following four criteria should be strictly observed. First, there must be a real threat of systemic risk materializing. Second, there is no alternative to the provision of central bank funds. Third, appropriate measures must be taken to prevent moral hazard. And fourth, the financial soundness of the BOJ must not be impaired. However, those criteria have not been observed, strictly speaking, in several cases of failure that occurred in the 1990s.
2. See Suzuki, Kuroda and Shirakawa (1989) for more details about the traditional way of reserve management conducted by the BOJ.
3. In order to cope with the credit crunch, the government introduced an emergency policy package in October 1998. The package included 20 trillion-yen credit insurance facilities available for small companies through the Credit Insurance Public Corporation. Meanwhile, the BOJ temporarily increased the amount of CP purchases and introduced a special scheme for providing BOJ loan to financial institutions that increased their lending to companies.
4. In order to streamline the public financial system, the *Japan Development Bank* and the *Hokkaido and Tohoku Development Corporation* will be merged to become the *Japan Policy Investment Bank* in October 1999. Similarly, the *Export and Import Bank of Japan* and the *Overseas Economic Co-operation Fund* will be merged to become the *International Co-operation Bank* in October 1999.
5. It should be noted that foreign banks are included in ordinary banks. As of end-March 2000, the number of foreign ordinary banks in Japan was 84.
6. The definitions of credit categories II, III, and IV are as follows. Category II is the credit for which banks have judged that detailed management is needed. Category III is the credit on which banks doubt collection in full, but have difficulties with accurate estimation of losses. Category IV is the credit that banks have judged to be non-collectible or of no value.
7. At the end of March 1992, there were 47 labor credit associates. Besides this, there were 3,446 agricultural co-operatives and 1,661 fishery co-operatives. Although the number of agricultural and fishery co-operatives is large, it is not

appropriate to consider them as being separate institutions since they are closely related to each other under the direction of the Ministry of Agriculture, Forestry, and Fishery.

8. As for the unfavorable tax system for investors, the securities transaction tax as well as the exchange tax were abolished in April 1999, while the capital gains tax will be reformed in April 2001.
9. According to the Foreign Trade and Foreign Exchange Law of 1998, banks and money-exchangers are now legally required to verify the identity of counterparties for foreign remittance and, in cases involving the export or import of means of payments (such as cash), a reporting system involving the customs authorities has been introduced. Moreover, in August 1999, three laws related to the prevention of organized crimes were passed in the Diet. Among those laws, measures to prevent money laundering were included.
10. Moreover, the Mint Bureau, the Print Bureau, and the Institute for Fiscal and Monetary Studies were special institutions of the MOF headquarters.
11. It should be noted that the Advisory Group on the Central Bank, the advisory council to the Prime Minister Hashimoto, started deliberations on the revision of the BOJ Law in the same context and issued its report in November 1996.
12. The merger between the *Fukutoku Bank* and the *Naniwa Bank,* so as to establish a new bank named the *Namihaya Bank* in October 1998, was the only case that such amendment of the DIC Law was applied to. The amendment was abolished in March 1999 and, later that year, the *Namihaya Bank* failed (in August 1999).
13. There were about 30 cases of "financial assistance", including "special financial assistance," provided by the DIC until March 1998. Among them, notable cases of failure were the *Hyogo Bank* and the *Kizu Credit Co-operative* in August 1995, the *Taiheiyo Bank* in May 1996, the *Hanwa Bank* in November 1996, and the *Hokkaido Takushoku Bank* and the *Tokuyo City Bank* in November 1997.

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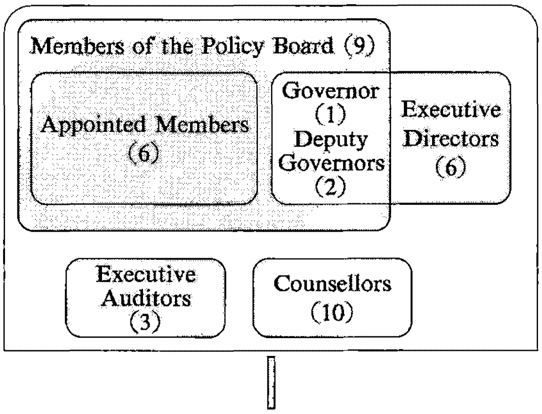
Chart 1 The Organization of the Bank of Japan



Depatment/office	Functions
Secretariat of the Policy Board Coordination Division Secretaries Division Diet Liaison Division Press Division	Arranges proceedings for Polioy Bard meetings; with the Diet, the media, and industry associations; reviews the content and wording of draft proposals for decision at Policy Board meetings and of other important documents from the legal perspective; handles legal matters regarding the Bank of Japan Law and other laws and ordinances; handles particular matters as directed by executives: supports the Executive Auditors in auditing; provides administrative servioces for executives; is responsible for the safekeeping of official stamps of the Bank and executives.
Internal Auditors' Office	Audits the Bank's operations.
Policy Planning Office Planning Division I Planning Division II Policy Research Division	Plans and formulates monetary policy measures and handles related matters.
Financial Markets Department Money and Capital Markets Division Open Market Operations Division Foreign Exchange Division	Determines the specifices of daily market operations; monitors and analyzes developments in financial markets in Japan as well as overseas, including foreign exchange markets, and activities of financial institutions in these markets; deals with issues relating to improvement of the functioning of the Japanese financial markets including the foreign exchange market; intervenes in the foreign exchange markets for the purpose of stabilizing the exchange rates as the agent of the Minister of Finance and/or on behalf of other countries' monetary authorities; conducts purchases/sales of foreign currencies on behalf of overseas central banks and international organizations for the purpose of assisting investment of their assets.
Research and Statistics Department Economic Research Division Economic Statistics Division Prics Statistics Division	Conducts research on the domestic economic and fiscal situation; complies statistics.

Depatment/office	Functions
Financial and Payment System Office Financial System Division Payment System Division	Plans and formulates measures that contribute to the maintenance of an orderly financial and payment system.
Bank Examination and Surveillance Department Planning Division Examination Division Surveillance and Monitoring Division	Conducts on-site examinations and off-site monitoring of client financial institutions that have current accounts with the Bank; judges financial institutions' eligibility to hold current accounts with the Bank and to have access to its lending facilities; determines the specifics of credit extension by the Bank to maintain an orderly financial system; liaises with financial industry associations.
International Department Planning and Coordination Division Global Economic Research Division Balance of Payments Division	Manages external assets held by the Bank; makes arrangements for investment in yen assets by overseas central bank and international organization; conducts operations for international financial support; liaises with overseas central banks and international organizations; conducts research on global economic and financial conditions; conducts business entrusted to it by the Ministry of Finance related to the Foreign Exchange and Foreign Trade Law and Foreign Exchange Fund Special Account Law.
Gurrency Issue Department Planning and Management Division Cash and Custody Division Currency Verification Division	Conducts planning and operations relating to banknotes; conducts payment/receipt of coins, and examines and takes custody of them; exchanges banknotes and coins unfit for further circulation; conducts business related to clearing of bills and check; manages securities and other items entrusted to the Bank for safekeeping.
Operations Department Planning and Coordination Division Operations Control Division Agency Supervision Division Money Markets Division Settlement Service Division Treasury Fund Business Division Treasury Accounting Division Government Bond Certificate Division	Conducts banking operations including the following: (1) discounting of bills; (2) loan extension; (3) purchasing/selling of bills (including those drawn by the Bank) and securities; (4) borrowing/lending of securities with cash collateral; (5) accepting deposits; (6) domestic funds transter; (7) taking custody of bills and securities as collateral; (8) purchasing/selling of gold and silver bullion; (9) bidding and underwriting Japanese government securities; (10) operations relating to treasury funds; (11) handling of government affairs related to currency and finance; (12) business operations of policy measures to maintain an orderly financial system; and (13) conducting other banking business of the Bank not listed above and operations relating to the Bank's agents.
Information System Services Department Systems Planning Division Systems Development Division Systems Operation Division	Manages to design and development of the Bank's computer systems as reguired in order to automate the Bank's business procedures; operates the Bank's computer systems.

Depatment/office	Functions
Pubic Relations Department Pubilc Information Division Documents and Library Division Savings Information Division	Is responsible for public relations; disseminates information on financial services; administers the Bank's library.
Budget and Management Office Planning and Coordination Division Budget Division	Plans and formulates measures relating to the organization and resources of the Bank; is responsible for the Bank's budgeting.
Human Resources Management Department Planning and Administration Division Personnel Division Human Resources Development Division	Handles personnel policy issues relating to recruitment, assessment of job performance, career planning and training, wages and salaries, the Bank's ethical discipline code, and other aspects of personnel administration.
Administration Department Planning and Coordination Division Premises Management Division General Supplies Division Welfare Division Security and General Services Division	Condusts administrative operations relating to the following real estate holdings, supplies, staff welfare, security, transportation, payment of expenses, subscription certificates of the Bank's capital, mailing, and safekeeping of slips.
Institute for Monetary and Economic Studies Research Division I Research Division II Research Division III	Studies theoretical, institutional, technological, and historical aspects of monetary and economic issues; collects, preserves, and exhibits historical materials and documents related to monetary and economic issues; exchanges views on monetary and economic issues with academics.
Branches	The 33 branches mainly conduct operations relating to currency issue and banking operations, and research on the economic and financial situation in each area.
Local offices in Japan	The Fuchu computer center operates the Bank's systems. The other 12 local offices handle some of the operations of the head office or branches.
Oversear Representative Offices	The 6 overseas representative offices perform a liaison function, gather information, and conduct research.

(Source) The Bank of Japan Homepage (http://www.boj.or.jp)

Chart 2　Categorization of Japanese Financial Institutions

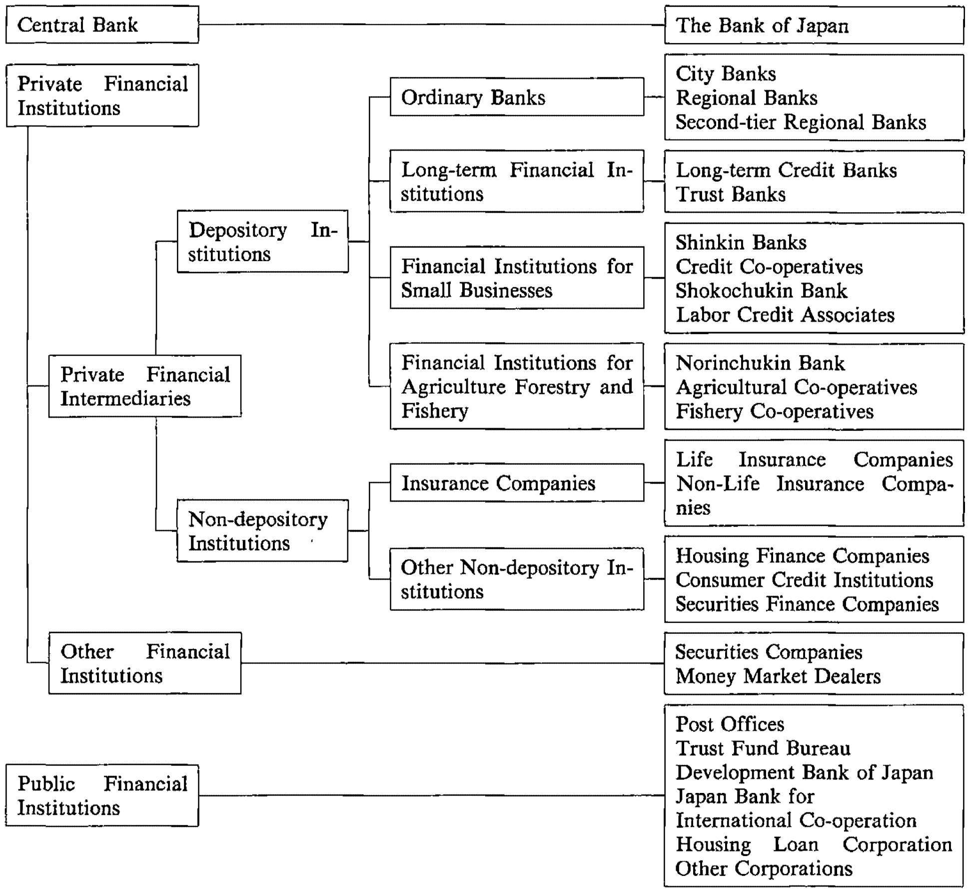


Chart 3　Regulatory and Supervisory Agencies in Japan: Pre-and Post-August 1998